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Under Secretary Wallis

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Commodity Markets and Commodity Agreements

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Following is an address by Allen Wallis, Under Secretary for Economic Affairs, before the National Coffee Association, Boca Raton, Florida, February 11, 1986.

This morning I will discuss the International Coffee Agreement (ICA).

The United States has been a party to this agreement since 1962. We have a right to withdraw on 90 days notice, and, in fact, we cannot remain in the agreement after next September unless we obtain explicit authority from Congress to do so.

For about a year we have been studying the advantages of the agreement—not only the direct advantages to the United States but also the indirect advantages through effects on friendly countries. The issues are complex, but we expect to reach a conclusion by spring.

As background for discussing the coffee agreement, I will point out some general characteristics of commodity prices. Then I will consider efforts to control the movement of commodity prices. Finally, I will talk about the ICA itself. I want to emphasize that no decision has been reached about our continued participation and that the decision will not be based on economic considerations alone.

Trends and Characteristics of Commodity Prices

Turning first, then, to trends and characteristics of commodity prices in general: we are experiencing currently an interesting and instructive period in international commodity markets. In recent years, there has been a weakening of the price of internationally traded oil, and it has fallen dramatically in the last few weeks. In recent years, also, there have been substantial drops in the prices of other commodities. Since 1980, the prices of most major commodities, measured in inflation-adjusted dollars, have declined by one-third. As a result, the prices paid by U.S. consumers for internationally traded primary commodities other than fuel, after adjustment for inflation, are lower than at any time since the Second World War.

Coffee provides one of the few significant exceptions to the downward trend in commodity prices. Since the end of 1980, the inflation-adjusted dollar price of coffee has risen almost 50%—or even more, depending on which day you make the calculation.

Among the many influences on commodity prices, one of special importance was the ending of over 15 years of high inflation and the attendant temporary recession in economic activity. Commodity prices are especially sensitive to these economic fundamentals. In addition, a large part of the reason for the weakness of dollar prices of commodities has been the strength of the U.S. dollar. Commodity prices expressed in terms of other major currencies have strengthened as the world economy has recovered. A world index of real commodity prices has risen since 1982, along with steady, though modest, economic recovery outside the United States and strong recovery in the United States.

After correcting for fluctuations in exchange rates, the major determinant of inflation-adjusted commodity prices appears to be the rate of world economic growth. A recent study by Data Resources, Inc., indicates that if in the 24 countries of the Organization for Economic Cooperation and Development (OECD) economic growth is faster than 2.6% annually, commodity prices tend to rise; and if the OECD countries grow more slowly than 2.6%, commodity prices tend to fall.

Specific commodities are subject to their own specific influences, such as the powerful effect that frost and drought have on coffee prices. Those specific influences temporarily obscure the longer term trends, which otherwise would have been about the same for coffee and other special cases as for commodities in general.

These special cases, however, illuminate certain features common to the markets for most commodities. Most commodities have volatile prices; they are highly sensitive to shortages or surges of supply. From a policy standpoint, the volatility of commodity prices is especially significant because it stimulates efforts to control markets in the hope of stabilizing them.

Cartels

The reason for the volatility of the prices of most primary commodities is that they face highly inelastic demand in the short run.

Demand is termed inelastic if a change of the quantity available by a given percentage results in a larger percentage change of the price in the opposite direction. If demand is inelastic, suppliers can obtain more revenue from a smaller supply than they can from a

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larger supply. The increase in price will more than offset the decrease in sales.

For many commodities, supply, too, is inelastic in that even a large increase in price brings forth only a small increase in quantity. Indeed, unless this is true, it is not possible to increase revenue by raising the price of a commodity whose demand is inelastic. The increase in price will simply elicit increased supply and, thus, restrain the rise in price. In these circumstances, there is a strong incentive for the suppliers to form a cartel and agree among themselves to hold down supply.

A complication to this is that elasticities of both demand and supply increase with time. In the very short run, consumers may face extreme difficulty in reducing consumption, and producers may find it virtually impossible to increase supply. So in the short run, cartels can be effective—at least, they could be in theory if they could discipline their members, something which history shows they seldom can do for long. Each producer has a strong incentive to expand his output surreptitiously and, thus, get a free ride on the restraint of the others. But, in time, all things are possible: consumers find substitutes or learn to do without, and suppliers find new mines, bring new trees to maturity, convert machinery, or train new workers. In the long run, both demand and supply become highly elastic.

Oil is providing us with a classic example. In the early 1970s, as a seemingly insatiable demand for oil rapidly outstripped additions to reserves, the Organization of Petroleum Exporting Countries (OPEC) was able to triple prices. In 1979, after the Iranian revolution, panic buying by consumers enabled OPEC to increase prices a further 160%. The United States assisted the cartel by holding domestic oil prices below international levels and subsidizing the excess in price of imported oil. Energy analysts were predicting a steady increase in the real price of oil and continued dependence on OPEC oil.

The reverse has happened. Why? First, President Reagan decontrolled domestic oil prices, thus halting our subsidy to OPEC. Then, the high international price of oil stimulated three basic responses by consumers and producers.

First, they used oil more efficiently. The amount of oil used in relation to gross national product (GNP) of industrialized countries has dropped 30% in the past 11 years.

Second, substantial additional supplies of non-OPEC oil came on the market.

Third, coal, fission, and gas were substituted for oil, and, to some extent, even wind, sunshine, waterfalls, and geothermal resources.

The long-run price elasticities of demand and supply turned out to be large. OPEC could maintain prices only by reducing its production. Since 1979, demand for OPEC oil has decreased by about 50%. OPEC is facing the problem of all cartels in a falling market: how to share the pain of reduced production and revenues.

There is a similar story for bauxite. For the last 30 years, bauxite has been a principal source of foreign exchange earnings for Jamaica. In the early 1970s, the then-socialist Government of Jamaica sought to draw other nations into a bauxite cartel. When other countries did not join, Jamaica unilaterally raised its prices by imposing a steep export levy. For a time, buyers had no option but to pay the price. Jamaica garnered greatly increased foreign exchange revenues, and the Jamaican Government enjoyed greatly increased revenues. Higher prices, however, stimulated the development of new capacity to produce bauxite in Guinea, Brazil, and Australia. Jamaica, which produced 15 million tons of bauxite in 1974, is now producing less than 6 million tons annually. The international bauxite market is awash with excess capacity, and prices are weak. Jamaica now confronts this weak market hampered by a bloated public sector that owes its existence to tax revenues from bauxite.

These attempts to stabilize the oil and bauxite markets illustrate the general tendency for such attempts to boomerang on producers who attempt them. They illustrate also the importance of the special characteristics of commodity markets that I referred to earlier—inelastic demand and, consequently, volatile prices. These characteristics are a never-ending temptation to governments and other interested parties to intervene in one way or another to influence the course of prices. These characteristics give rise to seductive arguments, effective even in importing countries, favoring more intervention.

In commodity markets, efforts to control prices sometimes can succeed in the short run, but they eventually fail. Then, when the market collapses, the effects on producers are disastrous, and they last a long time because of surplus stocks and excess capacity hanging over the market. The depth and duration of the hardship exceeds whatever benefits were achieved by the temporary reduction in volatility.

International Commodity Agreements

When we consider other forms of intervention, such as international commodity agreements with both producers and consumers participating, we should bear in mind the informational function of a free price system. Prices are a decentralized system of communication and incentives that makes the economy efficient.

- Prices convey information. They tell what is wanted and how much it is wanted in relation to the prices of the things that will be given up to provide it.
- Prices furnish an incentive to adopt the least costly methods of production and, thereby, use resources for their most highly valued purposes.
- Prices determine how income is distributed.

All these points have a bearing on the arguments for and against participating in international commodity agreements and can be used to test the soundness of the arguments.

An international commodity agreement usually has as its principal aim to stabilize the prices of the commodities it covers. On the surface, "stabilize" seems to refer only to reducing the volatility of commodity prices that I discussed a few moments ago. Commodity agreements do, in fact, try to do that. In addition, however, the term "stabilize" often takes on the connotation of "support"—to hold the price higher, on the average, than it would be in a free market. If an agreement does that, it transfers income from consumers to producers, and it obstructs the informational function of prices.

With either meaning of the term "stabilize," but especially with the first (reducing volatility), a commodity agreement attempts to support the price during a temporary downswing by accumulating stocks, either in an official buffer stock or in stocks of producing countries. Then, when the price rises in a year of exceptional scarcity, these stocks are released to the market to mitigate the scarcity and limit subsequent price increases.

There are four main arguments in favor of an international agreement that attempts to stabilize a commodity price.

First, more stable prices smooth out producer incomes and provide better price predictability to consumers, to the mutual benefit of both. Businessmen greatly prefer such predictability.

Second, such agreements usually transfer income from wealthy countries to poor countries, thus providing economic aid that cannot be obtained through regular governmental appropriations.

Third, both of the first two effects increase economic and political stability in the producer countries, which is desired by the U.S. Government and by other governments of developed countries. Most small countries cannot easily diversify their output or otherwise pro-

tect themselves against unstable receipts from a major export.

Fourth, a successful commodity agreement protects and furthers the commercial and political interests of the United States and other developed countries in the producing countries and helps achieve better relations overall.

These arguments are all plausible. It is difficult, however, to find any actual experience, systematic data, or valid analysis to support them. In fact, it usually turns out in practice that commodity agreements have effects very different from those intended and expected. There are at least eight reasons for the discrepancy between idealistic intentions and practical reality.

- The reference prices set in these agreements typically are too rigid and do not adequately reflect market conditions.
- Because prices generally are supported at higher than equilibrium levels, suppliers produce more than consumers are willing to absorb.
- Inefficent producers are protected and new entrants are attracted into the market, thus creating even greater oversupply. If there are quotas, new entrants with lower production costs may find it difficult to enter the market.
- Private speculators hold lower stocks due to the price limit defended by the buffer stock. Then they rush to sell their stocks if market trends undercut the viability of the buffer stock. Such sales can quickly overwhelm the buffer stock's capacity.
- Consumers are led by high prices to develop substitutes that they would not use at a lower price.
- When prices are maintained at too high a level, the forces I have mentioned will eventually exhaust the funds available to a buffer stock organization set up to defend the reference price.
- The inevitable collapse of the commodity agreement will result in a sharp drop in price. The large stocks that were accumulated will keep prices depressed for some time. In the long run, therefore, price instability may be even more damaging with international commodity agreements than without them.
- The financial costs of operating these agreements often are substantial.

The current crisis in the tin market provides an example. In this case, the operation of the buffer stock and favorable currency movements kept the nondollar price artificially high, masking both the real trend and the inadequacy of the members' financial support. Eventually, the sleight of hand was no longer possible. When, in 1985, the dollar turned down, the tin price fell, and the buffer stock faced heavy losses on futures contracts. The member countries were unwilling to provide further support, the buffer stock was unable to cover its sudden losses, and tin trading on the London Metal Exchange (LME) was suspended. Negotiations among tin council members, banks, and brokers have not yet found a solution that will allow the LME tin market to reopen.

The disadvantages of commodity agreements are practical and borne out by long experience. Nevertheless, I mentioned earlier the theoretical arguments presented to show that, under certain circumstances, commodity agreements could increase the welfare of both producers and consumers by reducing price variability. While these arguments often seem to be wishful thinking, ideological, or abstract, it is important to take a pragmatic approach and examine carefully whether an actual or proposed commodity arrangement might be beneficial. In that spirit, let's examine the particular case of coffee.

International Coffee Agreement

The ICA differs from other commodity agreements in which the United States has participated in recent years (namely, sugar and rubber) in that it has no buffer stock and no rules governing the accumulation and release of official stocks in producer countries. If all its provisions were fully implemented, however, including the prohibition on sales at discounted prices to nonmember importing countries, it would work in a manner very similar to a buffer stock arrangement. It imposes quotas on exports by producer countries to member importing countries at times of price downswings, but there is no provision for restricting production. If nonmember countries have to pay the same prices for coffee as do member countries, the quotas force the accumulation of stocks that can be sold at a time of scarcity and high prices, such as we have this year. The relaxation and subsequent suspension of quotas as prices rise make the accumulated stocks available to mitigate the scarcity. That is the theory of how it should work.

The U.S. Government is concerned about income levels and income stability in many of the countries that depend heavily on coffee for their export revenues; in fact, most of those countries receive various forms of aid from us directly and indirectly through international organizations to which we are the principal contributor. These points, together with those I set out earlier on the arguments for commodity agreements in general, are the reasons why the United States joined the ICA and are the principal arguments for staying in.

We do not believe, however, that all is well with the coffee agreement. During some periods, the agreement has maintained prices above the appropriate level. To the extent that it supports prices that are above the long-run equilibrium level, the agreement levies a hidden tax on consumers and subsidizes production in exporting countries. There is no precise estimate of the excess cost to consumers caused by the ICA—in fact, the amount obviously varies from year to year and may even be negative in 1986—but some estimates for some years are several billion dollars.

Some argue that we should accept this transfer on the grounds that it provides aid to developing coffee-producing countries. Such "aid," however, is unconditional and indiscriminate. Unlike most economic assistance, this aid cannot be conditioned on the adoption of sound economic policies or directed to specified purposes, so it does not encourage economic development and reform—more likely the opposite, in fact. Furthermore, such aid goes to all producers—including some countries to which the United States would not offer aid, for example, Cuba and Nicaragua.

Finally, it is unsound public policy to force consumers to provide money for a public purpose that is not subject to congressional appropriation and oversight.

When stocks accumulated in recent years, many members sold coffee at a discount to nonmember countries. Through the operation of the two-tier market, the Eastern bloc has received benefits in the form of cheaper coffee, estimated to average about $110 million per year.

The ICA's pricing policy may well be contrary to the long-term interest of producers. Since 1962, when the United States joined the ICA, coffee consumption per capita in the United States has declined more than 40%. Tea consumption, in contrast, has not changed, and soft drink consumption has more than tripled.

Once a commodity agreement is launched, it requires ever more complex and onerous regulatory mechanisms to ensure that all members abide by their commitments. In the coffee agreement, for example, the problem of "tourist coffee"—nonmember shipments which find their way into the member markets with windfalls to the traders involved—is met with Resolution 329, entailing elaborate control and matching of import and export certificates. Similarly, the response to the problem of discount sales to nonmembers is Resolution 336—which, if enforced, would impose penalties for the practice. The possibility of penalties has become a bone of contention among consuming countries,

some of which include traders who profit from the business.

From a strictly theoretical point of view, the ICA might be operated in a manner that does a minimum of violence to the play of market forces. For the past 3 years, the U.S. delegation to meetings of the council has tried to persuade other delegations to put this approach into operation. To that end, we have sought large global quotas so that there would be a wide range in which these quotas would be more than sufficient to allow prices to be set by the free play of market forces. At the minimum prices defended by the quota system—that is, at a composite indicator price of $1.15–$1.20 per pound—we advocated much more stringent quotas to assure that the price stabilization function would be served. We also advocated strict enforcement of provisions against discount sales to nonmember countries, in order to assure that the supplies withheld from the market at times of low prices would be stockpiled and available to cover a crop shortfall—such as is now impending.

An obvious problem is the allocation of export quotas. To stabilize prices effectively, the agreement must allocate quotas according to an exporter's available supply; unfilled quotas must be reallocated to others quickly and efficiently. In fact, however, the rigidity of allocations under the ICA means that some members have difficulty filling their quotas. For others, many of them countries of importance to the United States, the quota allocation is insufficient to market their coffee to member countries, so they must find nonmember outlets for their production. This is the unfortunate outcome of any system of allocating quotas on the basis of export performance of an earlier period. In addition, reallocations of quotas are subject to political bargaining in the producer caucus, with no regard for a country's competitive ability or the political interests of consuming countries. This system causes overexpansion of coffee production in some countries and the languishing of the coffee sector in others, with very real losses of income and development potential. So far, we have made no headway in obtaining procedures for allocating quotas that are responsive to these considerations.

Similarly, we have been frustrated in our attempts to make the operation of the ICA more market oriented. Our adherence to the International Coffee Agreement gives our tacit blessing to what was intended to be a cartel arrangement to control coffee prices worldwide. For the reasons I've outlined earlier, such arrangements are inherently unworkable and carry the seeds of their own demise. In response to the price supports provided by the agreement, there have been large increases in production and reductions in per capita consumption.

This year's special circumstances in the coffee market have eliminated, or at least deferred, the problems of nonmember discount sales and "tourist coffee." We need the stocks which have been built to their present levels (whatever that level is) through years of encouraging production. What appeared a few months ago to be an excessive overhang of stocks now has become a source of reassurance for those concerned about price rises. We will be interested in the degree to which these stocks hold down prices in the next 2 or 3 years. While this is a useful function, offsetting at least in part the effects of excess prices earlier, it is a function that in free markets would be fulfilled at least as well (and probably at less cost) by speculators and brokers.

Although we have made some progress in getting our message across to the other governments, we have been disappointed by the overall results, and we have made it clear that our continued participation is in jeopardy.

I want to emphasize again that the question of continued U.S. participation in the ICA has not yet been decided. Both political and economic considerations must be weighed. We are making a comprehensive analysis, and we are consulting with major producing countries, the ICA, the domestic industry, and other departments of the U.S. Government.

President Reagan has worked to eliminate controls and regulations that are needless economic constraints and to create an environment conducive to private initiative and innovation. If we look at the economic record of the developing nations in the past several years, we find that the top performers are those in which the government has provided a climate where the private sector could prosper. These are the countries where the "magic of the market" has worked—where resources have been allocated to achieve the maximum return. Experience shows that fewer controls, not more, will encourage healthy and viable commodity markets, economies, and societies. ■

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